STATE OF ILLINOIS

ILLINOIS COMMERCE COMMISSION

Central Illinois Light Company	:	
	:	**02-0837**
Proposed general increase in natural gas rates.	:	
	:	

REPLY BRIEF ON EXCEPTIONS OF THE STAFF OF THE ILLINOIS COMMERCE COMMISSION

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Now comes the Staff of the Illinois Commerce Commission ("Staff" and "Commission"), through its Counsel, pursuant to Section 200.830 of the Illinois Commerce Commission's Rules of Practice (83 Ill. Adm. Code 200.830), and respectfully submits this Reply Brief on Exceptions to the Administrative Law Judges' Proposed Order ("PO").

I. ORIGINAL COST RATE BASE

A. Adjustment to YTD September 2002 Gas Plant Additions and Related Depreciation Expense (V. C. 1.)

The PO correctly concluded that the pro forma adjustments for post-test year plant additions should not be approved because the post-2001 net plant in service balance is less than the net plant in service balance at the end of the 2001 test year. (PO, p. 8) The record shows that CILCO has experienced a trend of declining net gas plant in service during the period from 1997 through 2002. (CUB/AG Cross Ex. 1). Under those circumstances, the PO appropriately concluded that "it is unwise to adopt a post-test year change that fails to account for accumulated depreciation." (PO, p. 8)

In spite of the downward trend of plant in service, CILCO's BOE attempts to justify the additions because they are known and measurable. The Company's argument that "...the Commission's rules mandate that the known and measurable plant additions be included in rate base, and failure to follow those rules is reversible error" (CILCO BOE, p. 3) is flawed in two respects. First, under the Commission rules, it is permissible, not mandated, for pro forma adjustments found to be known and measurable, to be included in rate base. Pro forma adjustments are adjustments to the test year based upon assumed or anticipated facts. In this case, the assumed facts are additions to rate base. However, the record is clear that rate base, in fact, is declining. For that reason, an adjustment assuming additions to rate base is inappropriate. Second, the case cited by CILCO does not support this argument. The Commission's decision was not overturned because it did not accept Commonwealth Edison's ("ComEd") pro forma adjustments. (*Commonwealth Edison Co. v. Illinois Commerce Commission*, 322, Ill. App.3d 846, 751 N.E.2d 196 (2d Dist. 2001)) The decision was reversed because the Commission categorically refused to consider the testimony by which ComEd offered the adjustments. (Id., at 853, 202) That is not the case in the docket at hand. The PO considered and rejected the Company's pro forma adjustment.

The Company appears to misunderstand the basis for the disallowance of the pro forma plant additions, even though it is explicitly stated in the PO, i.e., "net plant in service balance at the end of the 2001 historical test year appears to be more representative of net plant in service when rates go into effect." (PO, p. 8) The Commission has approved pro forma post-test year plant additions that are known and measurable in several cases prior to the instant proceeding. However, each case must be decided based on the particular facts and circumstances therein. The Company may propose, and the Commission must consider such pro forma adjustments, as they have done in this proceeding. Pro forma adjustments for significant known and measurable changes are made to historical balances in order to make the result more representative of future expectations. Based on the evidence presented in Docket 02-0837, the Company's net plant in service is declining. Therefore, the Company must not only demonstrate that the proposed plant additions are known and measurable, it must also justify why such pro forma additions should be reflected in rates, given the fact that post-test year net plant in service is actually declining, not being increased. The Company has not done so.

The Company argues that the Commission has approved known and measurable plant additions in many cases in recent years without requiring an update of depreciation. In particular, CILCO cites the decision in *Commonwealth Edison*, Docket No. 01-0423, as an example wherein the Commission found that it is inappropriate to update the historical test year to reflect accumulated depreciation. CILCO refers to the decision in *Commonwealth Edison Company*, Docket No. 01-0423, as supportive of its position that it is inappropriate to update the historical test year to reflect accumulated depreciation. The Order does conclude that a certain proposed depreciation reserve adjustment is flawed, and therefore, is not approved. (Docket No. 01-0423, Order, p. 45 (March 28, 2003)). Staff notes, however, that the circumstances of the proposed adjustment in Docket No. 01-0423 are not consistent with the facts of the instant proceeding because that order did not consider the effect of a declining net plant in service. The basis for the proposed adjustment to disallow the pro forma post-test year plant additions in the instant proceeding is the declining net plant in service trend that continued through 2002. The Company never justified its proposed increase for pro forma plant additions given that net plant in service was actually declining.

Therefore, the PO correctly disallows all post-test year pro forma plant additions due to the fact that the net plant in service balance is actually declining.

B. Adjustment to Capitalized Pensions and Benefits (V. C. 5.)

The PO correctly reduces CILCO's operating expense and rate base by $493,000 and $159,000, respectively, representing a correction of the Company's calculation of its 2003 capitalized pensions and benefits amount (PO, page 15) and an update of an estimate to final 2003 pensions and benefits expense. (PO, page 27) CUB/AG's BOE attempts to point out flaws in the PO's decision process. Staff considers the PO correct and CUB/AG's arguments without merit.

The PO finds that that CILCO's pensions and benefits adjustments, and Staff's corrections thereof, are nothing more than a reflection of a known and measurable change for a test year item. (PO, pages 15 and 27). CUB/AG suggests that the PO errors in allowing the updated pensions and benefits amounts because Ameren committed in the acquisition case, Docket No. 02-0428, that the instant proceeding would be based on pre-closing cost of service, and that CILCO's use of the Towers Perrin actuarial report represents a departure from such level. (CUB/AG's BOE, p. 6) CUB/AG previously presented this same argument. (CUB/AG Exhibit 1.1, pp. 8-9) Yet, the PO adopts use of the Towers Perrin actuarial report, as this report reflects the assumptions that will be used by CILCO on a going-forward basis. (PO, p. 26) Staff believes that the PO correctly interprets the commitment from Docket No. 02-0428 as it applies—or, rather, as it does not apply, to this issue.

The PO correctly concludes no double counting occurs from adoption of Staff's adjustment (PO, p. 15). CUB/AG continues to opine the opposite (CUB/AG's BOE, pp. 10-11), seemingly ignoring evidence to the contrary. CUB/AG's own witness admitted in his cross-examination that CILCO actually had pension income, not expense, in 2001, therefore it is impossible to double-count the rate base effect by using the 2003 numbers. (Tr., p. 408 and Staff Initial Brief, p. 20) Additionally, CUB/AG acknowledged CILCO's adjustment represents the incremental increase in capitalized pension and benefits from 2001 to 2003 (Tr., pp. 410-411 and Staff Initial Brief, p. 20), again, producing no double-counting.

CUB/AG's BOE also argues that there must be symmetry between the Commission's decision to disallow post-2001 test year additions to rate base, and any other upward adjustment to rate base. (CUB/AG's BOE, pp. 9-10) Yet, no such direct relationship exists. The pensions and benefits adjustments are based upon the 2003 Towers Perrin actuarial report, not any analysis of or calculation including rate base. It is not necessary to tie one conclusion to the other.

Further, CUB/AG accuses the PO of allowing single-issue ratemaking, which is the concept that expenses from outside the test year cannot be added without making corresponding adjustments for other revenues or other changes anticipated in the future. (CUB/AG's BOE, p. 9) CUB/AG must somehow misunderstand this concept, as Staff analyzed at least a half-dozen other pro forma adjustments to the test year, which consider the effect on future expense and revenues levels. (*See* CILCO Ex. 6.1, Sch. B-2.1 and C-3).

Finally, CUB/AG criticizes the Staff and CILCO for not citing similar adjustments to those proposed herein. (CUB/AG's BOE, p. 9) First, Staff's adjustments were based upon the evidence presented in this case. Staff's adjustments reflect corrections to and updates of a known and measurable change to a historical test year, which is hardly a new concept nor something not addressed in prior Commission Orders, whether cited or not. More importantly, though, prior Commission decisions are <u>not</u> a prerequisite to adjustments in a rate case. If that were the case, no new issues would ever be addressed by the Commission.

The PO is correct in adopting Staff's adjustments to pensions and benefits. Contrary to CUB/AG's assertions explained above, its conclusion is consistent with the Commission's practice of allowing known and measurable changes to historical test years. The PO correctly recognizes that the adjustments do not cause any double-counting, nor violation of the commitment made by Ameren in Docket No. 02-0428.

C. Stricken Lead/Lag Study

The PO correctly omits any discussion of this item because the supporting testimony and exhibits were stricken from the record, and the Company's Petition for Interlocutory Review of that decision was denied by the Commission. Accordingly, none of the parties addressed the lead/lag study, which supports the Company's proposed cash working capital component of rate base, in testimony, nor were any witnesses cross-examined about this issue during the course of the hearings. The record was marked "Heard and Taken" on June 12, 2003 and the Company has presented nothing new in the interim that would justify a reversal of the Commission's position.

For all the reasons given by Staff and CUB/AG in their motions to strike the testimony and exhibits presented by CILCO on this issue, as well as the preceding facts, it is inconceivable that the Commission would now allow the testimony and exhibits of CILCO witness Subbakrishna to be admitted into evidence in this proceeding, as CILCO proposes in its Brief on Exceptions. To so allow would result in extreme prejudice to Staff and Interveners. Therefore, the Commission should maintain its position to strike the testimony and exhibits presented by CILCO in support of a cash working capital allowance.

II. OPERATING REVENUES, EXPENSES AND INCOME

A. Adjustment to YTD September 2002 Gas Plant Additions and Related Depreciation Expense (VI. C. 1.)

The PO correctly adopts CUB/AG's recommendation to disallow depreciation expense related to all post-test year pro forma plant additions because the actual post-test year balance of net plant in service is less than the test year net plant in service balance and, consistent with the PO's finding, the associated assets were excluded from rate base. (PO, p. 20) This recommendation was made and supported by CUB/AG in direct testimony. (See CUB/AG Ex. 1.0, pp. 5-9, and Sch. B)

The Company argues that even if the Commission excludes the associated post-test year pro forma plant additions from rate base, that determination would not justify denying recovery of the depreciation expense related to those plant additions. (CILCO BOE, pp. 10-11) The Company further argues that a decline in the net plant in service balance does not affect the need for the utility to recover its investment either in existing plant or in post-test year plant additions at the time the new rates go into effect. (Id.)

As previously stated, pro forma adjustments for significant known and measurable changes are made to historical balances in order to make the result more representative of future expectations. Although the Company is entitled to propose such pro forma adjustments under the provisions of Part 285, and the Commission must consider such significant known and measurable changes to the historical information, as it has done in this proceeding, the Company must demonstrate how inclusion of the pro forma adjustment will make its rates more representative of future expectations. In the instant proceeding, the net plant in service was $194.6 million at the end of test year 2001. (CILCO Ex. 6.0 Sch. B-1, p. 1 of 1) At December 31, 2002 net plant in service had declined to $186.9 million as the increase in the accumulated reserve for depreciation more than offset the impact of plant additions through that date. (AG Cross Exhibit 1) Therefore, the net plant in service approved by the PO, $195.4 million (PO Appendix A, Sch. 3) appears more than adequate to allow the Company to earn a return on its actual net plant in service at December 31, 2002 of $186.9 million. Accordingly, the PO correctly disallows depreciation expense related to all post-test year pro forma plant additions.

Contrary to CILCO's protestations (see CILCO BOE, p. 11), the adjustment to depreciation expense should not be allowed when there is no asset to which it is linked. The facts in this case are not similar to the facts in Docket No. 83-0177, where CILCO was allowed to recover its investment, which the Commission determined was prudent, for a plant that was never put in service. In this docket, CILCO recorded both an increase in depreciation expense and an increase in accumulated depreciation in conjunction with its proposed pro forma plant adjustments.

If the pro forma plant additions are eliminated, as proposed by Mr. Effron and recommended by Staff, then the corresponding impact on both depreciation expense and accumulated depreciation must also be eliminated. The effect of failing to reduce depreciation expense would be to record depreciation on assets that are not reflected in rate base. From an accounting standpoint, that would not make any theoretical sense. Depreciation expense must be tied to the assets in rate base. There is no justification for depreciation expense, if there is no asset to which the expense is linked.

B. Income Tax Expense (VI. C. 3.)

The PO correctly adopts the recommendation of Staff and CUB/AG to disallow the remaining contested $68,000 of cushion adjustment related to the 2001 income tax expense calculation.

The Company argues that no party has shown any error in CILCO's correction of CUB/AG's proposed adjustment to income tax expense. However, the Company has not met its burden of proof to justify the inclusion of the remaining $68,000, which represents the effect on federal income taxes of deducting the state income tax provision true-up, as CILCO admitted. As AG/CUB witness Effron explained in his direct testimony, referring to CILCO's response to Information Request AG-4.4 (admitted into evidence as AG Cross Exhibit 4), "the effect on federal income taxes of the true-up to the provision for state income taxes is the result of a true-up to the provision for state income taxes posted in 2001 that is not deductible for federal income taxes." (AG/CUB Ex. 1.0, p.27) The Company must, therefore, explain why this amount should not be disallowed (220 ILCS 5/9 201(c)). The Company has failed to justify the additional $68,000 of expense, therefore, the PO correctly disallows this expense.

C. Adjustment to Pensions and Benefits Expense (VI. C. 7.)

Staff's argument is set forth fully in Section I. B. above and will not be repeated here.

III. COST OF CAPITAL AND RATE OF RETURN

A. Cost of Common Equity (VII. E.)

CILCO disagrees with the PO's reliance on Staff's recommended 10.47% return on common equity and argues that the PO understates the appropriate cost of capital for CILCO's risk level. (CILCO BOE, p. 14) CILCO's argument is unjustified as Staff witness Phipps estimated CILCO Gas' cost of equity using a sample of nine natural gas distribution companies comparable in risk to CILCO Gas ("LDC Sample"). Moreover, Ms. Phipps' LDC Sample comprises the same companies as CILCO witness Lesser's gas sample, excepting Ms. Phipps' inclusion of New Jersey Resources ("NJR"). (Staff Initial Brief, p. 37) NJR's 10.44% DCF-derived cost of equity estimate exceeded the average 10.28% DCF-derived cost of equity estimate for Ms. Phipps' LDC Sample. (Staff Ex. 9.0, Schedule 9.5) Thus, Ms. Phipps' inclusion of NJR in the LDC Sample does not result in a lower cost of equity estimate than would have been derived had she excluded NJR from the LDC Sample.

Furthermore, CILCO's argument is unjustified given Ms. Phipps estimated CILCO Gas' cost of equity using two theoretically sound methodologies that the Commission has consistently relied upon: the discounted cash flow ("DCF") model and the capital asset pricing model ("CAPM"). (Staff Initial Brief, pp. 35-39) Although Dr. Lesser also employed the DCF model and the CAPM to estimate CILCO Gas' cost of equity, he employed an improper risk premium model ("RPM") and used improper inputs for all three models (i.e., the DCF model, CAPM and RPM). Furthermore, Dr. Lesser mechanistically implemented those models without providing adequate support or basis for many of his assumptions. (Staff Initial Brief, pp. 57-62) Dr. Lesser's misapplication of financial models resulted in an upwardly biased cost of equity recommendation that, if adopted, would overcompensate CILCO's shareholders at the expense of CILCO's ratepayers.

The difference between Staff's cost of equity estimate and CILCO's estimate is primarily due to the following four differences in their analyses, which were addressed in Ms. Phipps' testimony and summarized in Staff briefs. First, to estimate CILCO Gas' cost of equity, Dr. Lesser relied, in part, on an invalid version of the risk premium model that lacks a basis in financial theory. (Staff Initial Brief, pp. 53-57) Second, Ms. Phipps' DCF analysis correctly used single day stock prices whereas Dr. Lesser's DCF analysis improperly used historical average stock prices. (Staff Reply Brief, pp. 23-26; Staff Initial Brief, pp. 41-46) Third, Ms. Phipps correctly used the current U.S. Treasury bond yield as a proxy for the risk-free rate whereas Dr. Lesser improperly averaged a forecasted U.S. Treasury bond yield and a risk-free rate derived from economic forecasts, which Ms. Phipps proved could not reflect investors' expectations. (Staff Reply Brief, pp. 26-27; Staff Initial Brief, pp. 47-50) Finally, Dr. Lesser's CAPM analysis used Value Line betas, whereas Ms. Phipps's CAPM analysis used both Value Line betas and regression betas that were calculated using the Merrill Lynch methodology. (Staff Reply Brief, pp. 27-29; Staff Initial Brief, pp. 51-53)

CILCO erroneously claims that Staff provided no explanation of why its regression beta estimates differed from Value Line and wrongly concludes that the difference is due to statistically invalid regression betas resulting from Ms. Phipps' use of monthly data to calculate the regression betas. (CILCO BOE, p. 16) Ms. Phipps calculated beta using the Merrill Lynch methodology. She described the Value Line and the Merrill Lynch methodologies in direct testimony and testified that neither methodology is superior to the other. (Staff Initial Brief, p. 51, citing Staff Ex. 3.0, pp. 25-27; Tr., at 333) Although the Merrill Lynch and Value Line methodologies use different stock price observation frequencies, both methodologies use five years of data. Moreover, Value Line betas are no more likely to be relied upon by investors than Staff's regression beta since other published betas are calculated using the Merrill Lynch methodology. (Staff Initial Brief, p. 52, citing Tr., at 333 and 335)

CILCO also errs when it relates the frequency of the stock price observations used to estimate beta and the statistical significance of those beta estimates. CILCO's leap in logic from the stock price observation frequency to the statistical significance of Ms. Phipps' regression beta is unsupported by record evidence. CILCO errs further when it argues that a beta's validity and reasonableness can only be measured by the statistical significance of the beta estimates. (CILCO BOE, p. 17) The measure of statistical significance with which CILCO attempts to discredit the Merrill Lynch betas indicates only whether an estimate of some unobservable phenomenon (such as beta) is really different from zero at some level of confidence. Statistical significance has nothing to do with whether that estimate accurately measures that phenomenon. If the phenomenon were close to zero, an accurate estimate of that phenomenon would also be close to zero. That is, CILCO's argument is problematical because the statistical tests that CILCO refers to are a function of the magnitude of the beta estimate (i.e., the lower the beta estimate, the lower the test statistic). That is, statistical significance is not relevant to the validity of beta estimates since the closer a beta is to zero, the less likely it would be statistically different from zero. (Staff Reply Brief, p. 28)

The record contains nothing that suggests betas cannot be near zero. To the contrary, beta estimates, particularly utility beta estimates, can be near zero. CILCO passed on two opportunities to present evidence (in rebuttal and surrebuttal testimony) that the statistical significance of beta estimates is relevant to the validity of beta estimates, which Staff could have challenged in testimony or during cross-examination. (Staff Reply Brief, pp. 28-29) Yet, in briefs, CILCO improperly urges the Commission to make a ruling regarding whether the statistical significance of regression betas has any bearing on their accuracy without a fully developed evidentiary record. Moreover, if a beta must be statistically significant to be "sufficient" then CILCO's preferred Value Line betas would be questionable at best since Value Line does not provide <u>any</u> statistics for its beta estimates. (Staff Reply Brief, p. 28 and Staff Initial Brief, p. 52, citing Staff Ex. 9.0, p. 36) Contrary to CILCO's allegations, Ms. Phipps' regression beta is valid and appropriate for use in her CAPM analysis.

Referring to Ms. Phipps' regression beta estimates, CILCO argues:

> …Merely running a model to get calculations provides no intrinsic indication of the validity and reasonableness of these calculations. Rather, the validity and reasonableness can only be measured by the statistical significance of the beta estimates that result from those regressions. This is one of the fundamental tenets of basic statistical inquiry: empirical proof of effect is measured by the statistical significance of the measurements. Reasonableness of the calculations themselves is a necessary condition for acceptability, but not a sufficient one. Sufficiency can only be met if the calculations have statistical validity.

(CILCO BOE, p. 17.) CILCO implies that Ms. Phipps merely ran a regression model without examining the results of her analysis. To the contrary, Ms. Phipps examined the intercept value of her regression analysis to determine whether the regression beta contained a systematic source of bias. (Tr., p. 339.) Furthermore, Ms. Phipps uncontroverted testimony refutes CILCO's argument that the validity and reasonableness of regression analysis can only be measured by the statistical significance of the regression beta. During cross-examination, Ms. Phipps testified that statistical significance is irrelevant to the validity of regression beta estimates. (Tr., p. 339.)

For the first time in its BOE, CILCO introduces "...one of the fundamental tenets of basic statistical inquiry: empirical proof of effect is measured by the statistical significance of the measurements." (CILCO BOE, p. 17) CILCO's broad generalization regarding the "fundamental tenet of basic statistical inquiry" fails to specify the "measurements" to which if refers. CILCO also asserts, "Sufficiency can only be met if the calculations have statistical validity" but fails to define "statistical validity" and how "statistical validity" is determined. (Id.) Staff agrees that beta estimates must be valid but disagrees that the f-statistic has any bearing on the validity of a beta estimate. (Tr., p. 339.) Rather, Staff asserts that intercept value resulting from beta regression analysis, which Ms. Phipps did examine, is the indicator of beta validity. Ms. Phipps found that the intercepts of her beta estimates were very close to zero; thus, she concluded that her regression beta is valid and reasonable for use in her CAPM analysis.

Regarding Dr. Lesser's improper version of the RPM,[1] CILCO claims, "The additional perspective provided by the RPM is valuable because of the unusual volatility of the stock market and the current unusually low interest rates." (CILCO BOE, p. 17) CILCO does not explain the basis for this puzzling statement, which is unsurprising because that statement is clearly false. To the contrary, the Lesser RPM provides no additional valid insights into the cost of equity estimation process at all. The Lesser RPM would be identical to the CAPM were it not for its substitution of a risky debt rate for the risk-free rate. That substitution has no basis in financial theory and systematically overestimates the cost of equity for companies with betas less than one, including the companies composing Dr. Lesser's gas sample. (Staff Initial Brief, pp. 54-55) Despite the similarities between the Lesser RPM and the CAPM, the Lesser RPM estimated a 12.50% cost of equity for his gas sample while his CAPM produced 11.60% and 11.80% cost of equity estimates for his gas sample. (Staff Initial Brief, p. 36, citing CILCO Ex. 7.10 Rev., pp. 32-33) In testimony, Dr. Lesser attempted to justify the higher cost of equity derived using his improper version of the RPM by alleging that the Lesser RPM may show a higher cost of equity than the CAPM (which reflects only non-diversifiable risk) since the RPM reflects diversifiable risk in addition to non-diversifiable risk. (Staff Initial Brief, p. 54, citing CILCO Ex. 7.10 Rev., p. 30) The flaw of Dr. Lesser's logic is demonstrated by the fact that the RPM produces lower cost of equity estimates than the CAPM when beta exceeds one. (See Staff Initial Brief, p. 55) Thus, the Lesser RPM should be rejected. The Lesser RPM provides no additional value in this proceeding nor does it provide any additional perspective relating to CILCO Gas' cost of equity. Thus, the PO's rejection of the Lesser RPM should not be changed.

[1]Hereafter, Dr. Lesser's version of the RPM will be referred to as the "Lesser RPM."

In a last attempt to win a higher allowed cost of equity, the Company asserts that the Commission should allow CILCO Gas a return on equity that is between Staff's 10.47% estimate and CILCO's 11.73% estimate. (CILCO BOE, pp. 14-15) Staff disagrees with arbitrarily choosing a rate of return for CILCO Gas. CILCO's proposal would set a poor precedent for future rate case proceedings by effectively endorsing cost of equity analyses that improperly use historical stock prices in the DCF model, improper risk-free rates of return and an improper risk premium model. Thus, the PO's decision to allow CILCO Gas Staff's recommended 10.47% return on common equity should not be changed.

IV. COST OF SERVICE AND RATE DESIGN

A. Allocation of Storage Costs (VII. E. 2.)

CILCO ignores material differences between the storage services provided to sales and transportation customers when taking exception to the PO's establishment of separate delivery rates for sales and transportation customers in the same rate class. (CILCO BOE, pp. 22-25) The Company claims that proposed changes to its transportation tariffs align transportation customers' storage access with sales customers' storage access. CILCO argues that these changes warrant a fundamental change in the Company's sales and transportation rates. CILCO proposes to assess the same delivery charges and recover the same storage costs from transportation and sales customers. (CILCO BOE, pp. 23-24) Record evidence demonstrates differences between the storage services provided to sales and transportation customers and justifies adjustments to either CILCO's proposed storage cost allocation or CILCO's proposed storage capacity allocation. (See Staff Ex. 6.0R-2, p. 9; Staff Ex. 12.0, pp. 6-

10) Both Staff and IIEC have argued that transportation customers have limited, if any, ability to use their storage banks for supplemental supply or seasonal hedging. (Id.) (IIEC Ex. 1.0, pp. 10-12; IIEC Ex. 2.0, pp. 3-4)

Throughout the course of the instant proceeding, CILCO has failed to demonstrate that transportation customers can use their storage banks for "supplemental supply" or seasonal hedging in the same manner that the Company uses storage to serve sales service customers. (Staff Ex. 12.0, p. 6) Further, the Company has failed to demonstrate that its proposed allocation of storage costs related to the supplemental supply function is commensurate with its allocation of transportation customer bank capacity. Staff attempted to reconcile CILCO's storage capacity allocation with the Company's storage cost allocation by tying the calculation of a transportation customer's positive bank tolerance to seasonal throughput – the same measurement that CILCO used to allocate the storage costs associated with supplemental supply. CILCO argued that Staff's seasonal throughput allocation of storage capacity would result in a greater allocation than the Company's proposed 10 peak days of bank but never explained why Staff's proposed storage cost allocation was inappropriate given the Company's proposed storage cost allocation. Staff argued that it was appropriate to allocate a greater amount of storage capacity because such an allocation was consistent with the Company's proposed storage cost allocation.

CILCO tacitly acknowledges the difference in storage service between sales and transportation customers when it recommends an alternative cost allocation that shifts costs away from customer classes that include transportation customers. (CILCO BOE, p. 23) However, CILCO's proposed reallocation would lower the rates of both sales and transportation customers to reflect the limitations on storage services that apply only to transportation customers. Shifting the cost burden away from both sales and transportation customers in the same rate class would result in a subsidy from transportation to sales service and not reconcile the fundamental differences that exist between sales and transportation customers' storage services.

Staff believes that the PO recognized the inconsistency between the Company's proposed storage cost allocation and the Company's proposed bank capacity allocation. (PO, p. 94) Instead of adjusting the bank capacity allocation to make it commensurate with the storage cost allocation as recommended by Staff, the PO adjusted the allocation of storage costs to reflect the Company's proposed bank allocation by adopting IIEC's alternative storage cost allocation proposal. (Id.) The Company's arguments against this allocation should be rejected.

B. Rate 600 Customer Service (VII. E. 3.)

The Company states that it is willing to accept the limited customer charge of $750 from $1,350, as stated in the PO, if it is allowed to utilize the declining block structure for the consumption charge. (CILCO BOE, p. 18) Staff disagrees with the Company on two points. Staff continues to support the customer charge being set at full cost of service. Additionally, throughout this proceeding Staff has and continues to advocate a flat rate, rather than a declining block structure, in order to convey the price signals to conserve energy.

The Company is being inconsistent by accepting the limited customer charge. Throughout the docket the Company has argued in favor of full cost of service for the Rate 600 customer charge. Staff and the Company agreed upon full cost of service for the Rate 600 customer charge. Any reduction to the “excessive” increase of the customer charge, as described by the PO, will not change the revenue requirement allocated to this customer class. The revenue requirement increase will simply be proportioned differently between the customer charge and the consumption charge based on the decreased customer charge in the PO. Staff continues to recommend full cost of service for the customer charge for this customer class.

The Company proposes to return to a declining block structure for this rate class. The declining block structure does not convey to ratepayers the proper price signals to conserve energy. This lower tail block rate serves as an incentive for ratepayers to increase their gas consumption. This is not an appropriate price signal to send customers. The rates should be designed to encourage ratepayers to conserve. Conservation is necessary because there is a consumption cost that is not directly captured in the price of gas. That cost is an environmental cost. Each therm of gas consumed has an adverse effect and thereby creates a cost to the environment. This is a cost paid by society as a whole. To the extent that ratepayers conserve, there will be less costs to the environment and society, as a whole, will benefit.

Staff witness Harden proposes replacing CILCO’s declining rate block proposal with a flat delivery charge for Rate 600, Large Users. The flat rate sends a more consistent price signal to consumers because it does not reward higher usage with a lower unit rate. By removing this incentive, the proposed delivery rate encourages ratepayers to conserve, rather than consume. And to the extent that ratepayers do curb their consumption, the environmental costs will decline.

Staff witness Harden proposes the Customer Charge should be $1,350 per month. On page 96 of the PO the paragraph referring to the customer charge should be deleted and the following sentences inserted.

> ~~The Commission is concerned, however, that the magnitude of CILCO's proposed increase to the Rate 600 large user customer charge is excessive. To mitigate this concern, the Rate 600 large user customer charge will be limited to $750 per month in this proceeding, which still represents a substantial increase. CILCO shall collect the remaining customer-related costs for this group of customers through the consumption charge. In the Commission's view, this represents a reasonable result that properly balances the principle of setting rates at cost with the principle of gradualism, or limiting the magnitude of rate increases so such increases are not overly burdensome on customers. The Commission makes no finding here as to how the Rate 600 large user customer charge will be established in future rate proceedings.~~
>
> <u>The Company and Staff agreed to full cost of service for the Customer Charge of the Rate 600 Large User customers. This is consistent with charging customers full cost of service. Based on full cost of service for the Customer Charge, the Company and Staff also agreed to a flat consumption charge rate, which the Commission finds reasonable as no party objected to this proposal.</u>

In the event that the $750 Customer Charge is accepted from page 96 of the PO, the PO should define whether the consumption charge should be calculated as a flat rate or a declining block rate as originally proposed by the Company. The word “flat” should be added before the words consumption charge in the 4th paragraph, 6th sentence.

> The Commission is concerned, however, that the magnitude of CILCO's proposed increase to the Rate 600 large user customer charge is excessive. To mitigate this concern, the Rate 600 large user customer charge will be limited to $750 per month in this proceeding, which still represents a substantial increase. CILCO shall collect the remaining customer-related costs for this group of customers through the <u>flat</u> consumption charge. In the Commission's view, this represents a reasonable result that properly balances the principle of setting rates at cost with the principle of gradualism, or limiting the magnitude of rate increases so such increases are not overly burdensome on customers. The Commission makes no finding here as to how the Rate 600 large user customer charge will be established in future rate proceedings.

V. CONCLUSION

For the foregoing reasons, the Staff of the Illinois Commerce Commission respectfully requests that the Commission order reflect Staff's recommendations.

September 5, 2003

Respectfully submitted,

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